Explain two methods of Full Costing together with a discussion of the advantages and disadvantages of each method

The concept of full costing is not to look into individual costs, for example variable costs, but to look at the whole picture and all the costs that are associated with achieving some objective, i.e. making a product, or providing a service. The logic of full costing is that all of the costs of running a particular facility, for example a building, are part of the cost of the output of that building. For example, the rent is a fixed cost that will not alter if we only produce one unit, but if the building were not rented then there would be nowhere for production to take place, therefore rent is an important element in the cost of each unit of output.

> *'Full costing: Deducing the total direct and indirect (overhead) cost of pursuing some activity or objective'*
> *(Accounting: An Introduction, McLaney &Atrill (2002) Page 564)*

Now we have a reasonable understanding of what full costing entails, we can look at some of the many methods of it. The two most renowned methods of full costing are Activity Based Costing, otherwise known as ABC, and Absorption Costing. Both of these methods are practiced in business today, as ways of allocating overheads to associated units of production. Absorption Costing is looked upon as being the more traditional approach, which has been updated with ABC. Both of these methods of full costing have their benefits and drawbacks, which I will look into over the course of this essay. But in order to fully understand each method, we need to first define what each one means. Absorption Costing can be defined as,

> *'The allocation of specific pools or groups of fixed costs to associated units of production by a predetermined percentage or pound amount, based on unit cost, machine or labour hours, or other factors'. (http://www.bridgefieldgroup.com/glos1.htm)*

Like any other factor, Absorption Costing has its advantages and disadvantages, for example, as mentioned above, it uses predetermined overhead rates to allocate fixed overheads to production. In the long-run, for a business to make any profits, sales must cover all the product's costs. By including fixed overheads in the product's costs, the long-run sales price can be set to cover all costs, including fixed overheads. As we can see this is one of the major advantages in Absorption Costing, as it really stresses the importance of fixed costs. Also by allocating costs to the production units, Absorption Costing works out the entire production cost for a product. Absorption Costing is thought to be more appropriate for seasonal business, as it prevents the reporting of false or inaccurate losses.

Although Absorption Costing is a recognised way for allocating costs to production, and is used by many industries today it does have its drawbacks. The predetermined rates imply to some managers that a fixed overhead is a variable cost. For example, if the predetermined rate for a fixed overhead is £5 per direct labour hour, it is possible to conclude (wrongly) that fixed overheads vary with changes in direct labour hour usage. Product lines may be dropped based on this assumption even though the products contribute to the overall positive cash flow of the firm. For this reason it is much harder for management to understand and interpret, and therefore can lead to flawed decision making.

Activity Based Costing, the other method of full costing, can be defined as,

> *'A technique for more accurately relating overheads to specific production or provision of a service. It is based on acceptance of the fact that overheads do not just occur but are caused by activities, such as holding the products in store which 'drive' the costs.'* *(Accounting: An Introduction, McLaney &Atrill (2002) Page 559)*

Activity Based Costing is considered to be a more updated and improved version of Absorption Costing, but like Absorption Costing it also has its drawbacks. Some of the benefits of Activity Based Costing are that it spots those customers, products and departments that are contributing the most and least profit to the organisation. From this information managers can see areas of strength and weakness within the business and thus make decisions regarding how the business is handled and organised. From this information managers can also predict costs, profits and requirements associated with changes in production, structure and costs. ABC additionally tracks the costs of activities and the development of work through the business, highlighting areas of high expenditure. Managers are able to analyse results from ABC and discover the areas that need improvement.

The drawbacks of ABC are also apparent, the whole process involved in ABC, i.e. analysis of overheads and identifying cost drivers is time-consuming and costly. It is argued that the cost and effort put into this process does not outweigh the benefits and so does not justify carrying it out. ABC is also criticised about its ability to provide relevant information for managers to carry out decision-making, as the results show past costs and not opportunity costs.

> *'Past costs are irrelevant in decision making and opportunity costs can be very significant, full costing information is an expensive irrelevance'* *(Accounting: An Introduction, McLaney &Atrill (2002) Page 329)*

Despite the drawbacks and criticisms of ABC and Absorption Costing, they are widely used in business today as a means of allocating direct and indirect costs to an activity or objective.

Bibliography

Accounting: An Introduction, McLaney &Atrill (2002), FT Prentice Hall

Management Accounting for Non-Specialists McLaney &Atrill (2002), FT Prentice Hall

Management and Cost Accounting Second Edition, Horngran, Bhimani, Datar & Foster (2002) FT Prentice Hall

www.bridgefieldgroup.com